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Central Intelligence Agency



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DIRECTORATE OF INTELLIGENCE

25 November 1983

Brazil's Efforts at StabilizationSummary

The Figueiredo government was slow to meet its economic adjustment commitments to the IMF in the early months of 1983. This was largely due to heightened sensitivity to potential internal pressures in Brazil's rapidly liberalizing political environment and to external factors beyond the government's control--mainly bank withholdings of pledged funds. As a result, by May Brazil officially fell out of compliance with IMF terms and the Fund suspended support. Since then, however, the government has become convinced that much stronger adjustment is needed and has taken several major steps to achieve it. We judge that Brasilia has made significant progress in efforts to meet IMF targets, is operating at or near the margins of its ability to keep its major political objectives on track, and has paid substantial short-term economic and political costs. Further, even though we believe that Brazil will continue with tough but much needed adjustments, these will be necessary but not sufficient conditions for compliance with IMF programs. This memorandum addresses only the degree of Brasilia's commitment, rather than the feasibility of the targets or the forecasts of significant external factors that will bear on Brazilian performance.

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This memorandum was requested by the Martin Feldstein, Chairman, Council of Economic Advisers. It was prepared by [redacted] South America Division, Office of African and Latin American Analysis and was coordinated with the Directorate of Operations. Information as of 1 November 1983 was used in preparation of this paper. Questions and comments may be directed to Chief, South America Division, ALA [redacted]

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A Cautionary Note

Estimating to what degree Brazil is currently adjusting its economy in accordance with IMF targets is difficult because of the scarcity of relevant timely data. Although there is considerable evidence from intelligence sources that the government recognizes the need for retrenchment as a precondition for economic recovery, Brazil has no centralized information network that generates reliable, comprehensive, and timely data on public-sector borrowing and expenditure, the keys to monitoring progress in reducing the public sector deficit. Details of Brazil's monetary performance also are sketchy and ambiguous. Although more and better indicators are available to gauge Brazil's external balance performance, they --like those of many other countries today--mask the effects of major events on capital account that are beyond the government's influence. Keeping those limitations in mind, this memorandum traces the chronology of Brazil's adjustment program in 1983 and assesses government intentions regarding the austerity program, and the relative successes and costs to date. [REDACTED]

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Original 1983 IMF Agreement

The IMF agreed at the beginning of this year to provide Brazil with \$5.9 billion in new loans through 1985--\$4.9 billion under a three-year Extended Fund Facility and \$1.0 billion from its Compensatory Finance Facility. In return, Brazil promised to implement major adjustments to its economy. High on the list were commitments to cut the previous year's current account deficit by more than half to \$7 billion, rebuild critically low exchange reserves, slash the public sector deficit from 13.8 percent to 7.9 percent of GDP, rein in monetary expansion, and roll back inflation from 100 percent annually to 70 percent. [REDACTED]

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According to the US Embassy, the government moved early in 1983 to slow the economy and strengthen external accounts. To reduce the public deficit, Brasilia ordered cuts in treasury spending, substantial reductions in state corporation investment, tax increases, and hikes in public-sector tariffs. The National Monetary Council tried to slow monetary expansion, in part by increasing interest rates for the agricultural sector and tightening eligibility standards for some subsidized credits. The government's economic team also announced a modification of wage policy to eliminate the practice of overcompensating most wage earners for the effects of inflation. []

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Early Problems with Compliance

Despite the adjustments, Brazil fell short of its IMF performance targets by May, prompting the Fund and foreign banks to suspend financial support. In the first quarter of 1983, inflation soared to an annualized rate of 130 percent, Brazil accumulated some \$600 million in external payments arrearages, and the public sector deficit overran its limit by 40 percent. []

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In our judgment, some of Brazil's troubles resulted from overly ambitious IMF performance assumptions and targets and an unwillingness of foreign banks to fulfill financial pledges. Notably, a smaller than predicted foreign demand for Brazil's exports and banks' withholdings of short-term trade credits and interbank deposits led to an acute foreign exchange squeeze during the first quarter, forcing Brasilia to run commercial arrearages. []

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To shore up its flagging foreign exchange position, the government was forced to undertake a large devaluation of the cruzeiro and, consequently, substantially augment inflationary pressures. As inflation accelerated, Brazil's indexation system automatically swelled the public sector deficit. []

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Other fault clearly lay with the Figueiredo government, however, for moving too slowly and indecisively in implementing monetary and fiscal restraint. In March, the government announced new programs to help small businesses obtain additional financing and measures aimed at lowering domestic interest rates. Additionally, during the first five months of 1983, the government made little headway in reducing subsidies or state enterprise spending. []

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The administration's tentativeness was the result, we believe, not so much of a lack of commitment to austerity but of a tactical decision to pursue a gradualist approach to adjustment. We believe its strategy was dictated by the following:

- Political liberalization had cost the government control of Brazil's political processes. In the November 1982 congressional elections, the government lost its majority in the lower house of Congress and has been in a weakened position to pass legislation to support the adjustment program.
- Simultaneously, sporadic disorders and protests among the population over deteriorating living standards raised government fears that harsh austerity measures would risk major social upheaval. A week of riots and looting in Sao Paulo in April especially sensitized the government.
- Brasilia had not developed the institutional capability to monitor and enforce tight fiscal discipline. Public sector spending has been spread over four budget groups--the central fiscal budget, the central monetary budget, the budgets of government-owned enterprises, and the state and municipal budgets. []

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Reinforced Austerity

Following a mid-year evaluation of the effectiveness of existing stabilization measures, [REDACTED] [REDACTED] Brazil's economic policy team agreed with the IMF that stronger measures were necessary. They conceded that the gradualist tack had not worked and advocated a course more closely akin to the shock treatment that appears to be working in Mexico. [REDACTED]

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The team devised a new and much more rigorous program to meet IMF objectives, despite mounting popular criticism of economic retrenchment. In June, the Figueiredo administration announced a series of steps to slash further the public sector deficit. It undertook additional heavy cuts in price and credit subsidies. During June and July, prices of petroleum products were raised 45 percent and the price of wheat was raised 100 percent. Steel prices and electricity rates have been raised substantially in real terms. Moreover, the government has pared considerably its subsidies for the agricultural and export sectors, not only strengthening the budget but rationalizing the country's interest rate structure. Brazilian authorities estimate that abolition of the various product and credit subsidies may save the government \$2 to \$3 billion a year. [REDACTED]

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Later in June, the government signed two new decree-laws aimed at cutting state enterprise investment and current spending. By squeezing another \$1 billion from state enterprise budgets, the government expects to cut real investment in 1983 to a level 25 percent below that of 1982. At roughly the same time, the Figueiredo administration established a new interministerial committee to monitor public sector budgets. [REDACTED]

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In July, after considerable controversy within the government, President Figueiredo also provisionally enacted a major wage decree-law--viewed as necessary by the IMF--that restricted wage increases to 80 percent of inflation. Because of the expected sharp drop in purchasing power for the lower

and middle income classes, however, popular opposition to this measure swelled. On 19 October, despite the government's imposition of emergency measures to shield the congressional proceedings from opposition agitators and to intimidate the legislators, the 80-percent wage adjustment decree-law was defeated by the Brazilian Congress. []

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Within a week, the Figueiredo government responded with a new compromise wage law that ultimately won Congressional approval. This time, the government negotiated in advance with dissident ruling party members and leaders of opposition parties. Under the new law, wage restraint is milder (permitting wage hikes averaging 87 percent instead of 80 percent of official inflation) and more progressive (using a sliding wage-adjustment scale). To partly offset the expansionary spending impact of the higher wage adjustments on the public deficit, the compromise wage law also provides for substantial increases in personal and corporate income taxes. To reduce the public sector deficit further, the government, according to the Brazilian press, also is planning deeper cuts in spending for state enterprises, including both investments and personnel fringe benefits. []

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Performance to Date

We judge that the government has made a good faith effort to meet the requirements of the IMF in the face of fairly severe economic and political costs. It has already set into motion a number of key stabilization policies that are bound to lead to major economic adjustment in the coming year. Moreover, although Brazil will continue to be constrained by the need to maintain political stability, we believe it will persist with tough but much-needed adjustments. []

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The protracted negotiations with the IMF, in our view, have obscured the Brazilian government's efforts and initial progress made in adjusting the economy. Details of Brazil's economic performance for 1983 are sketchy, but some early indicators probably are revealing. Brazil has made major gains in strengthening its current account balance and improving its

foreign exchange position. A \$4.9 billion cumulative January through September trade surplus should enable Brazil to surpass the IMF's yearend target of \$6.3 billion. Although suppressed imports have been primarily responsible for the growing surplus, increases in export earnings have also contributed since mid-year: an exchange rate policy that has depreciated the dollar value of the cruzeiro at a faster pace than domestic inflation has strengthened the competitiveness of Brazilian goods. In our view, it has been only because of the withholding of new foreign loans since May that Brazil has fallen behind in meeting its foreign reserve targets and has accumulated substantial arrearages. [REDACTED]

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Since May, Brazil also has shown determination in tightening monetary and fiscal policies to bring down inflation, in the view of the US Embassy.

- The monetary authorities have held expansion of Brazil's money supply and monetary base to annualized rates of less than 100 percent over the first nine months of this year and are likely to meet the IMF's targets for 1983.
- Over the same period, Brazil's fiscal budget showed a hefty surplus compared to that of last year, although this measure excludes trends in the monetary and state enterprise budgets.
- The US Embassy reports that the new interministerial committee appears to be having a significant impact in improving the overall budget implementation needed for IMF compliance. [REDACTED]

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Because of the impact of other structural adjustment measures and of adverse climatic conditions, however, the government's restrictive fiscal, monetary, and incomes policies have not yet had their intended effect on inflation. In our view, Brazil's inflation probably will double to about 200 percent by the end of this year, largely because of the price impact of extensive devaluations of the cruzeiro, the

withdrawal of oil and wheat subsidies, large crop losses from drought and floods, and an acceleration in the velocity of money--typical during periods of hyperinflation--that is likely to offset some of the tightness in monetary policy. [REDACTED]

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Austerity, combined with sluggish demand abroad, has had a severe impact on domestic economic activity and living standards. Gross domestic product probably will shrink 5 percent in 1983, Brazil's third successive no-growth year. Industrial production is expected to plunge at least 8 percent, according to the Sao Paulo Industrial Federation, the country's most important organization of manufacturers. Serious declines in sales are occurring in electrical and electronics goods, chemicals, capital goods, and cement as a result of cutbacks in government spending. Commercial defaults and private business failures are accelerating because of reduced public sector purchases, slumping consumer sales, tight credit, and price controls. Reduced industrial employment also has lowered real family incomes. In Sao Paulo about 13,000 industrial workers have been laid off monthly this year, reducing the number of jobs in the city to near the 1970 level. Members of the middle class, many of whom are losing their jobs or are being forced to accept less prestigious positions, are curtailing spending even on necessities, according to the press [REDACTED]

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Brazil's Efforts at Stabilization [redacted]

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